2018

A Collection of Accounting Case Studies Analyzing Financial Reporting

Jessica Lee Pearson
University of Mississippi. Sally McDonnell Barksdale Honors College

A COLLECTION OF ACCOUNTING CASE STUDIES ANALYZING FINANCIAL REPORTING

By
Jessica Pearson

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford
May 2018

Approved by

Advisor: Dr. Victoria Dickinson

Reader: Dean Mark Wilder

Abstract

The following thesis contains a group of twelve accounting case studies that were completed between August 2016 and May 2017. The cases deal with a number of different accounting topics including depreciation, inventory valuation, formatting financial statements, the new revenue recognition standard, leases, using the Codification Research System, internal controls, stock-based compensation, and deferred income taxes. Each of these cases were picked to follow along with what was being taught in Intermediate Accounting at the time, and they were useful in building on the information I was already learning. The cases provided a different way of looking at each of the topics, and they took my understanding on those topics to a higher level. Each chapter that follows contains one case that is unrelated to any of the other ones, and they should be viewed independently. Even though they are unrelated, when the cases are put together they form a complete work that showcases the journey take over those ten months.

TABLE OF CONTENTS

LIST OF TABLES

Case Number One:

Home Heaters: A Comparison of Glenwood Heating, Inc. and Eads Heaters, Inc.

The following case study is a look at two companies which are described below. This case study involved making journal entries for the companies, making their adjusting entries, and preparing financial statements for both Glenwood Heating, Inc and Eads Heaters, Inc. Lastly, a recommendation was made about which company seemed better off financially and which one was preferred to lend money to.

Two companies began operations at the beginning of 20X1. One was Glenwood Heating, Inc., and the other was Eads Heaters, Inc. These two companies sell heating units, and they had the same transactions during their first year of operations. Below are the journal entries for their 12 first year transactions, and a trial balance for them also. Both companies sold stock and took out a loan to acquire cash of $560,000 total. They also both bought a building, equipment, and land for a total of $500,000. Their $398,500 worth of sales were all on credit, and they collected $299,100 of that during the year. They spent $239,800 on their inventory and paid off $213,360 of that before year end. They also paid for advertising, supplies, insurance, and wages, and they paid dividends of $7.25 per share. The following tables show the account balances for Home Heaters, the journal entries made, and trial balance following those entries.

					Home Heaters						
	Cash	Accounts Receivable	Inventory	Land	Building	Equipment	Accounts Payable	Notes Payable	Interest Payable	Common Stock	Retained Earnings
1	160,000									160,000	
2	400,000							400,000			
3	(420,000)			70,000	350,000						
4	(80,000)					80,000					
5			239,800				239,800				
6		398,500									398,500
7	299,100	(299,100)									
8	(213,360)						(213,360)				
9	(41,000)							(20,000)			(21,000)
10	(34,200)										(34,200)
11	(23,200)										(23,200)
12									6,650		(6,650)
	47,340	99,400	239,800	70,000	350,000	80,000	26,440	380,000	6,650	160,000	313,450

Table 1A: Home Heaters account balances following journal entries for the year

2-Jan	Cash	160,000	
	Common Stock		160,000
2-Jan	Cash	400,000	
	Notes Payable		400,000
3-Jan	Land	70,000	
	Building	350,000	
	Cash		420,000
5-Jan	Equipment	80,000	
	Cash		80,000
	Inventory	239,800	
	Accounts Payable		239,800
	Accounts Receivable	398,500	
	Sales		398,500
	Cash	299,100	
	Accounts Receivable		299,100
	Accounts Payable	213,360	
	Cash		213,360
30-Sep	Note Payable	20,000	
	Interest Expense	21,000	
	Cash		41,000
	Other Operating Expenses	34,200	
	Cash		34,200
1-Dec	Dividends	23,200	
	Cash		23,200
31-Dec	Interest Expense	7,000	
	Interest Payable		7,000

Table 1B: Journal entries made throughout the year for Home Heaters

Home Heaters		
Trial Balance, Part A		
	Debits	Credits
Cash	47,340	
Accounts Receivable	99,400	
Inventory	239,800	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts Payable		26,440
Notes Payable		380,000
Interest Payable		6,650
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Other Operating Expenses	34,200	
Interest Expense	27,650	
	971,590	971,590

Table 1C: Home Heaters trial balance following journal entries

Glenwood Heating, Inc. and Eads Heaters, Inc. made different decisions when it came to how to make their adjusting entries on December 31st. Glenwood Heating predicted that one percent of accounts receivable will be uncollected, and Eads Heaters predicted that five percent will be. Therefore, Glenwood's bad debt expense is $994, and Eads Heater's is $4,970. Glenwood picked to use FIFO to keep track of their inventory and Eads used LIFO. This resulted in Glenwood having a higher ending inventory and a lower cost of goods sold. They also depreciated the building and equipment differently with Glenwood using straight-line for both, and Eads using straight-line depreciation for the building and double-declining balance depreciation for the equipment. Both companies are renting operating equipment. Glenwood is renting the equipment by the year, and Eads is signing a lease to rent it for eight years with eight percent interest. Finally, both Glenwood Heating and Eads Heaters are paying 25 percent of their net income to taxes to avoid a late payment penalty. Below are the journal entries and a trial balance for each company after these five adjusting entries.

Glenwood Heating, Inc						
Part B- Additional Information						
			Allowance for			
		Accounts	for			
Transactions:	Cash	Receivable	Bad Debts	Inventory	Land	Building
Balances, Part A	47,340	99,400		239,800	70,000	350,000
Part B (1) Bad Debts			(994)			
Part B (2) COGS				(177,000)		
Part B (3) Depreciation						
Building						
Equipment						
Part B (4) Equipment	(16,000)					
Rental payment						
Part B (5) Income Tax	(30,914)					
Balances	426	99,400	(994)	62,800	70,000	350,000

Table 1D: Glenwood Heating additional information journal entries

Glenwood Heating, Inc								
Part B- Additional Information								
Continued	Accumulated		Accumulated					
	Depreciation,		Depreciation,	Accounts	Note	Interest	Common	Retained
Transactions:	Building	Equipment	Equipment	Payable	Payable	Payable	Stock	Earnings
Balances, Part A		80,000		26,440	380,000	6,650	160,000	313,450
Part B (1) Bad Debts								(994)
Part B (2) COGS								(177,000)
Part B (3) Depreciation								
Building	10,000							(10,000)
Equipment			9,000					(9,000)
Part B (4) Equipment								(16,000)
Rental payment								
Part B (5) Income Tax								(30,914)
Balances	10,000	80,000	9,000	26,440	380,000	6,650	160,000	69,542

Table 1E: Glenwood Heating additional information journal entries continued

Eads Heaters, Inc							
Part B- Additional Information							
			Allowance for				Accumulated
		Accounts	for				Depreciation,
Transactions:	Cash	Receivable	Bad Debts	Inventory	Land	Building	Building
Balances, Part A	47,340	99,400		239,800	70,000	350,000	
Part B (1) Bad Debts			(4,970)				
Part B (2) COGS				(188,800)			
Part B (3) Depreciation							
Building							10,000
Equipment							
Part B (4) Equipment							
Rental payment	(16,000)						
Part B (5) Income Tax	(23,505)						
Balances	7,835	99,400	(4,970)	51,000	70,000	350,000	10,000

Table 1F: Eads Heaters additional information journal entries

Eads Heaters, Inc					
Part B- Additional Information					
Continued		Accumulated		Accumulated	
		Depreciation,	Leased	Depreciation,	Accounts
Transactions:	Equipment	Equipment	Equipment	Lease	Payable
Balances, Part A	80,000				26,440
Part B (1) Bad Debts					
Part B (2) COGS					
Part B (3) Depreciation					
Building					
Equipment		20,000			
Part B (4) Equipment					
Rental payment			92,000	11,500	
Part B (5) Income Tax					
Balances	80,000	20,000	92,000	11,500	26,440

Table 1G: Eads Heaters additional journal entries continued

Eads Heaters, Inc					
Part B- Additional Information					
Continued					
Transactions:	Note	Interest	Lease	Common	Retained
Balances, Part A	Payable	Payable	Payable	Stock	Earnings
Part B (1) Bad Debts	380,000	6,650		160,000	313,450
Part B (2) COGS					(4,970)
Part B (3) Depreciation					(188,800)
Building					
Equipment					(10,000)
Part B (4) Equipment					(20,000)
Rental payment					
Part B (5) Income Tax			83,360		(18,860)
Balances					(23,505)
	380,000	6,650	83,360	160,000	47,315

Table 1H: Eads Heaters additional journal entries continued (2)

Glenwood Heating, Inc		
Trial Balance, Part B		
	Debits	Credits
Cash	426	
Accounts Receivable	99,400	
All for Bad Debts		994
Inventory	62,800	
Land	70,000	
Building	350,000	
Accumulated Depreciation, Building		10,000
Equipment	80,000	
Accumulated Depreciation, Equipment		9,000
Accounts Payable		26,440
Notes Payable		380,000
Interest Payable		6,650
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Cost of Goods Sold	177,000	
Other Operating Expenses	34,200	
Bad Debt Expense	994	
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	9,000	
Rent Expense	16,000	
Interest Expense	27,650	
Provision for Income Tax	30,914	
Total	991,584	991,584

Table 1I: Glenwood Heating trial balance

Eads Heaters, Inc		
Trial Balance, Part B		
	Debits	Credits
Cash	7,835	
Accounts Receivable	99,400	
All for Bad Debts		4,970
Inventory	51,000	
Land	70,000	
Building	350,000	
Accumulated Depreciation, Building		10,000
Equipment	80,000	
Accumulated Depreciation, Equipment		20,000
Leased Equipment	92,000	
Accumulated Depreciation, Lease		11,500
Accounts Payable		26,440
Notes Payable		380,000
Lease Payable		83,360
Interest Payable		6,650
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Cost of Goods Sold	188,800	
Other Operating Expenses	34,200	
Bad Debt Expense	4,970	
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	20,000	
Depreciation Expense, Lease	11,500	
Interest Expense	35,010	
Provision for Income Tax	23,505	
Total	1,101,420	1,101,420

Table 1J: Eads Heaters trial balance

Below you will find a copy of Glenwood Heaters, Inc. and Eads Heaters, Inc. financial statements. This includes an Income Statement, a Statement of Changes in Stockholders' Equity, a Balance Sheet, and a Statement of Cash Flows for each company.

Glenwood Heating, Inc
Income Statement
For the Year Ending December 31, 20X1

Sales		398,500
Cost of Goods Sold		177,000
Gross Profit		221,500
Operating Expenses		
Bad Debt Expense	994	
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	9,000	
Other Operating Expenses	34,200	
Total Operating Expenses		54,194
Income from Operations		167,306
Other Expenses		
Rent Expense	16,000	
Interest Expense	27,650	
Total Other Expenses		43,650
Income before Taxes		123,656
Income Tax Expense		30,914
Net Income		92,742

Glenwood Heating, Inc
Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 20X1

	Common Stock	Retained Earnings	Total Equity
Beginning Balance	160,000	-	160,000
Net Income		92,742	92,742
Cash Dividends		(23,200)	(23,200)
Balance, December 31, 20X1	160,000	69,542	229,542

Glenwood Heating, Inc
Classified Balance Sheet
As of December 31, 20X1

Assets			
Current Assets			
Cash		426	
Accounts Receivable		99,400	
Less Allowance for Doubtful Accounts		(994)	
Inventory		62,800	
Total Current Assets			161,632
Plant Assets			
Buildings and Equipment	430,000		
Less Accumulated Depreciation	(19,000)		
Buildings and Equipment, Net		411,000	
Land		70,000	
Total Plant Assets			481,000
Total Assets			642,632
Liabilities			
Current Liabilities			
Accounts Payable		26,440	
Interest Payable		6,650	
Total Current Liabilities			33,090
Long Term Liabilities			
Notes Payable			380,000
Total Liabilites			413,090
Equity			
Common Stock		160,000	
Retained Earnings		69,542	
Total Equity			229,542
Total Liabilites and Equity			642,632

Glenwood Heating, Inc
Statement of Cash Flows
For the Year Ended December 31, 20X1

Cash from operating activities		
Net Income	92,742	
Depreciation Expense	19,000	
Increase in Bad Debt Expense	994	
Increase in Accounts Receivable	(99,400)	
Increase in Inventory	(62,800)	
Increase in Accounts Payable	26,440	
Increase in Interest Payable	6,650	
Net cash used by operating activities		(16,374)
Cash from investing		
Cash paid for land	(70,000)	
Cash paid for equipment	(80,000)	
Cash paid for building	(350,000)	
Net cash used by investing		(500,000)
Cash from financing		
Cash paid for dividends	(23,200)	
Cash received from issuing stock	160,000	
Cash received from note	380,000	
Net cash provided by financing		516,800
Net change in cash		426
Beginning Cash		-
End Cash		426

Eads Heaters, Inc
Income Statement
For the Year Ending December 31, 20X1

Sales		398,500
Cost of Goods Sold		188,800
Gross Profit		209,700
Operating Expenses		
Bad Debt Expense	4,970	
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	20,000	
Depreciation Expense, Lease	11,500	
Other Operating Expenses	34,200	
Total Operating Expenses		80,670
Income from Operations		129,030
Other Expenses		
Interest Expense	35,010	
Total Other Expenses		35,010
Income before Taxes		94,020
Income Tax Expense		23,505
Net Income		70,515

Eads Heaters, Inc
Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 20X1

	Common Stock	Retained Earnings	Total Equity
Beginning Balance	160,000	-	160,000
Net Income		70,515	70,515
Cash Dividends		(23,200)	(23,200)
Balance, December 31, 20X1	160,000	47,315	207,315

Eads Heaters, Inc.
Classified Balance Sheet
As of December 31, 20X1

Assets			
Current Assets			
Cash		7,835	
Accounts Receivable		99,400	
Less Allowance for Doubtful Accounts		(4,970)	
Inventory		51,000	
Total Current Assets			153,265
Plant Assets			
Buildings and Equipment	522,000		
Less Accumulated Depreciation	(41,500)		
Buildings and Equipment, Net		480,500	
Land		70,000	
Total Plant Assets			550,500
Total Assets			703,765
Liabilities			
Current Liabilities			
Accounts Payable		26,440	
Interest Payable		6,650	
Lease Payable		83,360	
Total Current Liabilities			116,450
Long Term Liabilities			
Notes Payable			380,000
Total Liabilites			496,450
Equity			
Common Stock		160,000	
Retained Earnings		47,315	
Total Equity			207,315
Total Liabilites and Equity			703,765

Eads Heaters, Inc
Statement of Cash Flows
For the Year Ended December 31, 20X1

Cash from operating activities		
Net Income	70,515	
Depreciation Expense	41,500	
Increase in Bad Debt Expense	4,970	
Increase in Accounts Receivable	(99,400)	
Increase in Inventory	(51,000)	
Increase in Accounts Payable	26,440	
Increase in Interest Payable	6,650	
Net cash used by operating activities		(325)
Cash from investing		
Cash paid for land	(70,000)	
Cash paid for equipment	(80,000)	
Cash paid for building	(350,000)	
Net cash used by investing		(500,000)
Cash from financing		
Cash paid for dividends	(23,200)	
Cash paid on equipment rental note	(8,640)	
Cash received from issuing stock	160,000	
Cash received from note	380,000	
Net cash provided by financing		508,160
Net change in cash		7,835
Beginning Cash		-
End Cash		7,835

Based off these financial statements, Glenwood Heaters, Inc. has a higher net income than Eads Heaters, Inc. by almost $20,000. It seems like Eads Heaters is being more cautious when they are stating their assets and inventory. They have a higher Allowance for Doubtful Accounts than Glenwood Heaters, and they depreciated their equipment at a faster rate giving them $11,000 less in equipment than Glenwood. Glenwood rented their operating equipment by the year, and Eads Heaters signed an eight-year lease. This gives Glenwood the option not to rent it next year if a better deal or better equipment comes around, but by Eads having a rental agreement already in place, they do not have to worry about the price going up on the equipment they already have. At this point in time, Glenwood only has $426 in cash while Eads has almost $8,000. Glenwood Heaters has a higher income from operations than Eads while Eads seems to be better at keeping cash on hand. Both companies have some strong points and some not so strong points.

Based off the current ratio, Glenwood has the better ability to pay their short-term debts than Eads with a ratio of 4.88 percent. Eads has a current ratio of 1.32 percent. Glenwood just has less debt in general, so I would be more comfortable lending them money. Also, Glenwood has a better return on total assets than Eads. Both companies have their strengths. They are very close in many aspects, but given all this information, I would rather invest or lend money to Glenwood Heaters, Inc. Even though Eads Heaters is being more cautious than Glenwood, Glenwood seems to be doing a better job of turning what assets they do have into a profit.

Case Number Two:

Totz and Doodlez: Researching Income Statement Questions Using the Codification Research System

This case introduced me to the Codification Research System which contains the accounting standards adopted by FASB. It answers questions relating to the income statement by pulling information from the Codification. The specific information regarding the companies in this case is listed below.

Totz manufactures is a clothing store that sells high quality children's clothing. These stores also contain art studios where kids can take a variety of art classes. These art studios are called Doodlez. The following information was determined after reading and researching some questions Totz had about how to report a few items on their income statement. The questions and answers are stated below.

1. In 2016, Totz had sales of $86.5 million, an increase of $12 million from 2015. This revenue was partly because of an increase in revenue from Doodlez. Doodlez had net sales of $11.2 million, and the remaining part of the increase was because the average transaction value for sales increased. On the income statement, we believe that these two sales numbers should be stated separately based on ASC 225-10-S99-2. An excerpt from ASC 225-10-S99-2 says,

> "Net sales and gross revenues. State separately:
>
> (a) Net sales of tangible products (gross sales less discounts, returns and allowances),
>
> (b) operating revenues of public utilities or others;
>
> (c) income from rentals;
>
> (d) revenues from services; and
>
> (e) other revenues."

Based on this statement, Totz net sales and Doodlez net sales should not be put together, but they should be listed separately when you are listing your sales on the income statement.

2. Gross profit also increased during 2016 a total of 8.6%. Just as net sales were not stated together, we think that the expenses should also be separated out from each other. Totz and Doodlez expenses should be distinct based off ASC 225-10-S99-2 again. Another part of the regulation states,

> "Costs and expenses applicable to sales and revenues. State separately the amount of
>
> (a) cost of tangible goods sold,
>
> (b) operating expenses of public utilities or others,
>
> (c) expenses applicable to rental income,
>
> (d) cost of services, and
>
> (e) expenses applicable to other revenues."

Totz does not include depreciation in cost of sales. This is allowable, but that information needs to be disclosed when showing the cost of goods sold. ASC 225-10-S99-8 answers any questions about this by saying,

> "If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income statement in a manner which results in reporting a figure for income before depreciation."

Therefore, just like the sales, we believe the cost of sales should be separated out based on whether it was used in Doodlez or not when you are making the income statement.

3. Also, during 2016, Totz moved its corporate headquarters to Mountain View, California. They abandoned the building and had a gain of $1.7 million. Originally ASC 225-20-45-4 said the sale of the building should not be recorded as an extraordinary item, but ASC 225-20-45-4 has been superseded by ASU 2015-01 which eliminates the use of extraordinary items at all. Here is a part of ASU 2015-01.

> "The objective of this Update is to simplify the income statement presentation requirements in Subtopic 225-20 by eliminating the concept of extraordinary items. Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Eliminating the extraordinary classification simplifies income statement presentation by altogether removing the concept of extraordinary items from consideration."

ASC 225-20-45-16 also states that this gain should be reported as a separate component of income from continuing operations. This statement is still pending because the original statement referred to extraordinary items which are no longer used. ASC 225-20-45-16 states,

> "A material event or transaction that an entity considers to be of an unusual nature or of a type that indicates infrequency of occurrence or both shall be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction shall be presented as a separate component of income from continuing operations or, alternatively, disclosed in notes to financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. Such items shall not be reported on the

face of the income statement net of income taxes. Similarly, the EPS effects of those items shall not be presented on the face of the income statement."

Therefore, the gain on the abonnement of the corporate headquarters should be placed in income from continuing operations as a separate component.

4. There was a class action settlement against one of Totz fabric suppliers. The lawsuit was settled, and Totz received $2.7 million in it. This money should be considered a cash flow from operation activities based off ASC 230-10-45-16 which says,

"All of the following are cash inflows from operating activities: …

c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits and refunds from suppliers."

Based off (c) in ASC 230-10-45-16, settling a lawsuit is considered a cash flow from operating activities, and it should be reported as such on the income statement.

Case Number Three:

Rocky Mountain Chocolate Factory, Inc: Completing and Formatting Financial Statements

Below you will find an income statement, a statement of changes in stockholders' equity, a classified balance sheet, and a statement of cash flows for Rocky Mountain Chocolate Factory for the fiscal year ended February 28, 2010. The purpose of this case was to learn how to format financial statements in excel and to get a sense of how financial statements are put together.

Rocky Mountain Chocolate Factory
Income Statement
For the Year Ending February 28, 2010

Sales		$ 22,944,017
Franchise and Royalty Fees		5,492,531
Cost of Goods Sold		14,910,622
Gross Profit		13,525,926
Operating Expenses		
Franchise Costs	1,499,477	
Sales and Marketing	1,505,431	
General and Administrative	2,422,147	
Retail Operating	1,756,956	
Depreciation and Amoritization	698,580	7,882,591
Income from Operations		5,643,335
Other Expenses		
Interest Expense	-	
Interest Income	27,210	27,210
Income before Taxes		5,670,545
Income Tax Expense		2,090,468
Net Income		3,580,077

Rocky Mountain Chocolate Factory
Statement of Changes in Stockholders' Equity
For the Year Ending February 28, 2010

	Common Stock	Retained Earnings	Total Equity
Beginning Balance	$ 179,696	$5,751,017	$5,930,713
Issue Common Stock	1,112		1,112
Net Income		3,580,077	3,580,077
Cash Dividends		(2,407,167)	(2,407,167)
Balance, January 28, 2010	180,808	6,923,927	7,104,735

Rocky Mountain Chocolate Factory
Classified Balance Sheet
As of February 28, 2010

Assets		
Current Assets		
Cash and Cash Equivalents	$3,743,092	
Accounts Receivable (Less Doubtful Accounts)	4,427,526	
Notes Receivable, Current	91,059	
Inventory	3,281,447	
Deferred Income Taxes	461,249	
Other	220,163	
Total Current Assets		12,224,536
Property and Equipment, Net		5,186,709
Other Assets		
Notes Receivable, Less Current Portion	263,650	
Goodwill, Net	1,046,944	
Intangible Assets, Net	110,025	
Other	88,050	
Total Other Assets		1,508,669
Total Assets		18,919,914
Liabilities		
Current Liabilities		
Accounts Payable	877,832	
Accrued Salaries and Wages	646,156	
Other Accrued Expenses	946,528	
Dividend Payable	602,694	
Deferred Income	220,938	
Total Current Liabilities		3,294,148
Deferred Income Taxes		894,429
Total Liabilities		4,188,577
Equity		
Common Stock	180,808	
Additional Paid-In Capital	7,626,602	
Retained Earnings	6,923,927	
Total Equity		14,731,337
Total Liabilites and Equity		18,919,914

Rocky Mountain Chocolate Factory
Statement of Cash Flows
For the Year Ending February 28, 2010

Cash from operating activities		
Net Income	$3,580,077	
Depreciation Expense	698,580	
Increase in Accounts Receivable	(197,793)	
Increase in Notes Receivable, Current	(91,059)	
Decrease in Inventory	783,164	
Increase in Deferred Income Taxes	(92,052)	
Decrease in Other	4,215	
Decrease in Accounts Payable	(196,811)	
Increase in Accrued Salaries and Wages	222,367	
Increase in Other Accrued Expenses	414,587	
Increase in Deferred Income	78,938	
Increaese in Dividend Payable	3,708	
Net cash provided by operating activities		5,207,921
Cash from investing		
Cash paid for Equipment	(631,691)	
Net cash used by investing		(631,691)
Cash from financing		
Cash paid for dividends	(2,403,458)	
Cash received from issuing stock	316,434	
Net cash used by financing		(2,087,024)
Net change in cash		2,489,206
Beginning Cash		1,253,947
End Cash		3,743,153

Case Number Four:

Cash and Receivables: Examining Potential Fraud Schemes and Internal Control Procedures

This case focused on fraud and how to detect that fraud. It was completed by working in groups to brainstorm different fraud schemes, and then an internal control was paired with each fraud scheme that could help detect that fraud. This case is about a local business in Oxford, Mississippi that needs help with their internal controls, and more information is discussed below.

As the owner of a small craft shop in Oxford, Mississippi, Ms. Kayla Stevens faces the possibility that fraud schemes are occurring at her local business. To safeguard the craft shop's operations, Kayla should implement internal control systems, which include checks and balances created to prevent and detect fraud. Table 4A identifies various fraud schemes and recommends internal control procedures to protect the business.

Fraud Scheme	Internal Control
Lucy may understate or not record sales as she has the power to both record sales and prepare bank deposits. Thus, Lucy could understate sales and pocket cash that she does not include with the bank deposits.	Separation of duties – Kayla should separate the responsibilities for receiving, depositing, recording, and reconciling cash so that an employee cannot both commit and conceal fraud. Clerks should collect cash during sales. A different individual should record daily sales, and Lucy may prepare bank deposits.
Kayla takes deposits to the bank and reconciles bank statements. This current system allows for embezzlement.	Separation of duties – While dividing all responsibilities may be difficult since the business is small, separation of duties provides greater internal control. One person should take deposits to the bank, and Kayla can reconcile bank statements.
Inventory purchases could be fraudulent since Kayla pays bills and monitors, records, and orders inventory. One could order inventory but then keep it for personal purposes instead of recording it in the inventory account. One could also write fraudulent checks for fake invoices.	Separation of duties – One clerk will order inventory with Kayla's authorization, and another clerk will record the inventory once it arrives in the store. Then, Kayla can pay invoices. Thus, no one has enough power to steal inventory and hide such behavior in the records.
Clerks may input fake or inaccurate transactions as they have authority for entering all types of transactions in the registers. The shop's new coupon program may allow clerks to enter false discounts and pocket the difference between the money collected and the sale recorded.	Access control – The types of transactions clerks can enter should be restricted, and employees should receive authorization before they can issue a refund or enter any irregular transaction into the cash register. This internal control should limit a clerk's ability to record an erroneous sale.

Fraud Scheme	Internal Control
The clerks' unlimited authority in entering transactions also allows Amanda, Becca, Sam, or Wendy to steal cash directly from the cash register.	Access control – Clerks should not remove cash without authorization. Requiring unique codes to use the register allows employee activity to be tracked, and Kayla should require the reconciliation of cash to check that the amount of cash on hand matches the receipts. To find a culprit, Kayla can give her employees vacation and see if cash discrepancies continue or end during a certain employee's time off.
The credit card machine is behind the cash registers. Clerks may steal credit card information or perform fraudulent actions since customers cannot see that their credit card transactions are performed correctly.	Physical control – Kayla should relocate the credit card machine next to the cash registers to ensure that the credit card is swiped, and that the transaction is properly completed at the correct price.
The amount recorded for sales or cash earned may be manipulated or presented inaccurately as the store's information system automatically updates inventory accounts while Lucy manually records sales in the accounting software.	Application and access control – Kayla can consider purchasing more sophisticated software that automatically records sales to prevent manipulation of data. If Lucy must enter sales manually, an access control should limit her access to other parts of the accounting software.
If transactions have no identification number or if register tape is not compared to the amount of sales journalized, Lucy or clerks can alter transactions without any matching supplemental records, and their actions will go unnoticed.	Application control – Kayla should use software that indexes each sale with details like the transaction number, date, amount, and clerk's name. This internal control provides unaltered evidence of sales for audits and allows the actual cash balance to be reconciled to the register tape's sales.
Lucy's locked office may allow her to operate in secret.	Physical control – Any business space is property of the business, and Kayla needs a key to Lucy's office to discourage any unauthorized actions. Kayla should keep a safe in her locked office for security.
Kayla has control of all other accounting functions, so she has the ability to commit fraud schemes such as embezzlement, misrepresenting net income, and stealing inventory.	Independent verification – Kayla should consider using an objective accountant to ensure the integrity of financial records. For example, a physical inventory count by external and internal parties can reconcile perpetual inventory records with the true amount of product sold.

Table 4A: Analyzing Fraud Schemes and Internal Control Procedures

Case Number Five:

Answering Inventory Questions using Selected Financial Statement Information

The following case contains questions and answers that were compiled using financial statements and other selected information that was originally provided, and this case focuses on inventory questions including inventory ratios and inventory obsolescence questions. More information is provided below.

Given selected financial statement information from 2011 and 2012, different questions about the inventory account for this company were answered.

1. Describe the three different types of inventory.

   Raw materials inventory consists of all the goods bought to manufacture the products. These goods have not yet been changed or processed. Work in process inventory is all the unfinished products plus any direct labor that has been used to manufacture the products. Also, a part of factory overhead is attributed to the work in process inventory. Finished goods inventory consists of the products that are finished and have not yet been sold and all costs associated with those goods.

2. What are inventories recorded net of?

   Inventories are recorded net of an estimated allowance for inventory that is not likely to be sold. This inventory is either obsolete or unmarketable, and therefore needs to be taken out of the inventory cost to accurately reflect the amount of inventory that can be sold.

3. Here is the information for the allowance for obsolete and unmarketable inventory account for 2012:

Balance, beginning of the year	$10,800
Provision	13,348
Write-offs, disposals, and other	(11,628)
Balance, end of the year	$12,520

a. Where does this account appear on the company's financial statements?

   This account should appear stated with the inventory accounts under current assets on the balance sheet. Gross inventory would be stated, and then less the allowance for obsolete and unmarketable inventory which would give you net inventory. Since it's a contra account to inventory, it behaves much like allowance for doubtful account.

b. What is the gross amount for inventory at the end of the last two years?

   The gross amount of inventory at the end of 2012 should be the net amount for 2012 plus the balance of the allowance for obsolete and unmarketable inventory account. So, 233,070 plus 10,800 which is 243,870 dollars at the end of 2012. The 2011 gross amount of inventory should be 224,254 dollars which is 211,734 plus 12,520.

c. What portion of the reserves for obsolete inventory comes from each of the three types of inventory?

   Most of the allowance for obsolete and unmarketable inventory comes from the raw materials inventory and the finished goods inventory. Goods are more likely to come in unusable or become obsolete than they are to break while they are being made. Approximately 40% of the allowance for obsolete and unmarketable inventory comes from raw materials and finished goods each, and 20% comes from work in process inventory.

4. Recreate the entries that were used to record the activity in the reserve account.

Cost of Goods Sold	13,348	
Allowance for obsolete and unmarketable inventory		13,348
Allowance for obsolete and unmarketable inventory	11,628	
Finished Goods Inventory		11,628

5. Set up five t-accounts and use them to analyze inventory activity during 2012.

Accounts Payable	
	39,012
	438,561
432,197	
	45,376

Raw Materials Inventory	
46,976	
438,561	
	442,068
43,469	

Work in Process Inventory	
1,286	
126,000	
442,068	568,735
619	

Finished Goods Inventory	
184,808	
	13,348
568,735	572,549
167,646	

Cost of Goods Sold	
0	
13,348	
572,549	
585,897	

6. Compute the company's inventory turnover ratio for 2011 and 2012.

The inventory turnover ratio is equal to the cost of sales divided by the net of the average inventories. For 2011 this comes out to 2.29 which is 575,226 divided by the average of 268,591 and 233,070. For 2012 the inventory turnover ratio is 2.63.

7. What is the inventory holding period for 2011 and 2012?

   The inventory holding period is defined as 365 divided by the inventory turnover ratio. Therefore, for 2011 it is 365/2.29 or 159.39 days, and in 2012 it is 138.78 days.

8. What percent of finished goods does the company estimate to be obsolete for 2012?

   Since the reserve for obsolete inventory relates entirely to finished goods, the company estimates that 7.22% of their finished goods inventory will be obsolete. That is 13,348 divided by 184,808. As an analyst, I would have liked to have known the purchases of this company for 2012. This would have made reconstructing the t-accounts easier.

Case Number Six:

Answering Depreciation and Income Questions Using Selected Information

This case focuses on depreciation, and it contains questions and answers relating to WorldCom and their fraudulent activities. More specific information is provided below, and these questions relate to appropriate depreciation techniques.

WorldCom was a company that incorrectly capitalized approximately $3.9 billion worth of costs around 2002. They were caught and eventually filed bankruptcy soon thereafter. The following questions were asked and answered regarding the incorrect capitalization that WorldCom reported.

A. FASB's Statement of Concept No. 6 describes the building blocks on which financial statements are reported.

   i. Explain how SCON 6 describes assets and expenses.

      Assets are anything that are going to benefit the company in the future in an economic way. Expenses are when you either use assets or incur liabilities to carry out business activities. These activities should have to do with the business's central operations.

   ii. In general, what costs should be expensed and what costs should be capitalized as assets?

      Expenses should be capitalized if they are going to create a long-lasting benefit with an asset. Then these costs are depreciated over the life of the asset.

B. What becomes of these "costs" after their initial capitalization?

   After costs are capitalized, they become part of the asset, and they are depreciated as the asset is depreciated. If a cost is capitalized, then income will be higher that year because the cost is going to be spread out over the life of the asset. Assets will also be higher than if the cost was expensed immediately.

C. What did the company report as line costs for 2001, and what are these line costs? Prepare the journal entry to record them.

Line costs are “access charges and transport charges” according to the reading. The journal entries to record line costs were as followed:

Line Cost Expense	14,739,000,000	
Cash		14,739,000,000

D. Describe the types of costs that were improperly capitalized by WorldCom. What gives rise to these costs, and do they meet the definition of an asset as stated in part A?

Line costs were improperly capitalized at WorldCom. These transactions consisted of charges paid to local telephone companies to complete calls. I do not think that these line costs meet the definition of an asset as described in part A because these costs were not going to benefit the company in the future like an asset does.

E. Prepare a journal entry to record the improper capitalization of the line costs. Where should these costs appear on the balance sheet and income statement?

These improperly capitalized costs appeared on the asset section of the balance sheet, and they were included in the operating activity section on the statement of cash flows. The journal entry to improperly capitalize these line costs is:

Property, Plant, and Equipment	3,055,000,000	
Line Cost Expense		3,055,000,000

F. Based on the information given, calculate and record the depreciation expense for 2001.

The depreciation expense for 2001 is calculated based on a useful life of 22 years. The calculation and journal entry follows:

771,000,000/22 years *(4/4 quarters) = 35,045,000

610,000,000/22 years *(3/4 quarters) = 20,795,000

743,000,000/22 years *(2/4 quarters) = 16,886,000

931,000,000/22 years *(1/4 quarters) = <u>10,580,000</u>

$83,306,818

Depreciation Expense	83,306,818	
Accumulated Depreciation		83,306,818

G. Determine WorldCom's net income if the line costs had not been improperly capitalized.

The difference in WorldCom's net income is substantial. Using a tax rate of 35%, the actual net income for 2001 is calculated below.

Income before Taxes, Reported	$2,393,000,000
Add Depreciation	83,306,818
Deduct Line Costs	(3,055,000,000)
Loss before Taxes, Restated	(578,693,182)
Add Income Tax Benefit	202,542,613
Add Minority Interest	35,000,000
Net Loss, Restated	$(341,150,568)

Case Number Seven:

Targa Company: Answering Restructuring Questions Using the Codification Research System

For this case, we once again returned to the Codification Research System to find information, but this time it is related to restructuring. Targa Company is the company that is talked about in this case, and more information about them can be found on the next page.

Targa Co. is discontinuing the development of a line in their business called Armor Track. Doing this will cause them to need to layoff many of their employees at one of their facilities, and this restructuring will also come with a relocation of a manufacturing operation to a different area. The following information was determined from researching in the Codification Research System.

1. The termination plan the company is going to use involves terminating 120 out of their 140 employees at this one facility. The ten-week termination benefit is estimated to cost $2.5 million, and the normal two-week severance should cost $500,000. This meets the criteria of being a one-time employee termination benefit based off ASC 420-10-25-4. ASC 420-10-30-6 says,

   "If employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date."

   This tells us that the liability should be recorded on the communication date, and the fair value of the liability is equal to the numbers above since the time between the events is so short. Also, the facility manager gets a lump-sum of $50,000 when the facility closes. Based off ASC 715-30-25-10, this lump-sum should be recorded as a liability and then a loss when it is paid. ASC 715-30-25-10 says, "An employer that provides contractual termination benefits shall recognize a liability and a loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated."

These benefits should be put in the financial statements as a component of income from continuing operations. ASU 420-10-S99 supports this and says,

"Question 1: May such restructuring charges be presented in the income statement as a separate caption after income from continuing operations before income taxes…? Interpretive Response: No. FASB ASC paragraph 225-20-45-16 (Income Statement Topic) states that items that do not meet the criteria for classification as an extraordinary item should be reported as a component of income from continuing operations."

2. There will also be a relocation cost of $500,000, and a staff training cost of $1.5 million. Lastly, there are irrevocable contracts with other parties that will be relevant for the next eighteen months. Since these contracts will provide no economic benefit to the company, ASC 420-10-25-13 tells us that they should be put on the books at the "cease-use date" as a liability. The exact wording is,

"A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be recognized at the cease-use date."

The relocation costs are supposed to be recognized when they are incurred and not before even if they come directly from the termination plan. This comes from ASC 420-10-25-15 which says,

"The liability shall not be recognized before it is incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of a plan. A liability for other costs associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred."

Case Number Eight:

Merck & Company: Answering Questions About Stockholder's Equity Using Selected Financial Information

This case focuses on stockholder's equity, and it is about Merck & Company. More information about the company is below. The topics for the questions include common shares, dividends, and treasury stock. Also provided is amounts and ratios for the company at year end.

Merck & Co. is a global pharmaceutical company that is listed on the New York Stock Exchange. They are research driven with the goal of improving human and animal health. Below is information and questions about their company from 2006 and 2007. These questions were answered using the financial statements and other information given.

A. Consider Merck's common shares.

   a. How many common shares is Merck authorized to issue?

      5,400,000,000

   b. How many common shares has Merck issued as of December 31, 2007?

      2,983,508,675

   c. Reconcile the number of shares issued to the dollar value reported on the balance sheet.

      (2,983,508,675) (.01) = $29,835,087

   d. How many common shares are held in treasury at December 31, 2007?

      811,005,791

   e. How many common shares are outstanding at December 31, 2007?

      2,983,508,675 - 811,005,791 = 2,172,502,884

f. If Merck’s stock price is $57.61 per share, calculate the total market capitalization of Merck on that day.

   (2,983,508,675) (57.61) = $171,879,934,800

B. Why do companies pay dividends on their common shares? What happens to a company’s share price when dividends are paid?

   It gives investors a return on their investment, and it shows them that the company is doing well. Also, it could signal to the investors that the company has run out of growth opportunities, so they’re paying dividends instead of reinvesting that money into the company.

C. In general, why do companies repurchase their own shares?

   There are many reasons companies might repurchase their own shares. One is that they feel the stock is undervalued, so they buy it low to resale it at a higher price. Also, they might be trying to “privatize” the company to prevent a takeover by someone. Lastly, these companies could be trying to stimulate a fake demand for their stock by buying it back.

D. Prepare a single journal entry that summarizes Merck’s common dividend activity for 2007.

Retained Earnings	3,310,700,000	
Dividends Payable		3,400,000
Cash		3,307,300,000

E. During 2007, Merck repurchased a number of its own common shares on the open market.

   a. Describe the method Merck uses to account for its treasury stock transactions.

      They use the cost method where the treasury stock is recorded at cost as opposed to par value.

   b. How many shares did Merck repurchase on the open market during 2007?

      26,500,000 shares

   c. How much did Merck pay on average to buy back its stock during 2007?

      In total Merck paid $1,429,700,000 which is $53.95 per share.

   d. Why doesn't Merck disclose its treasury stock as an asset?

      Treasury stock is a contra-equity account, not an asset account. Also, you can't have an economic benefit with your own stock, and that's the definition of an asset.

F. Below are some amounts and ratios for Merck for 2006 and 2007.

	2007	**2006**
Dividends Paid	$3,307,300,000	$3,322,600,000
Shares Outstanding	2,172,502,884	2,167,785,445
Net Income	$3,275,400,000	$4,433,800,000
Total Assets	$48,350,700,000	$44,569,800,000
Operating Cash Flows	$6,999,200,000	$6,765,200,000
Year End Stock Price	$57.61	$41.94
Dividends / Share	1.522	1.533
Dividend Yield	2.64%	3.66%
Dividend Payout	101%	74.9%
Dividends to Total Assets	6.84%	7.45%
Dividends to Operating Cash Flows	47.25%	49.11%

Case Number Nine:

Xilinx, Inc: Stock Based Compensation Questions

This case is about stock based compensation and how it relates to the company Xilinx. Topics discussed below include restricted stock units and employee stock purchase plans, and how all those things affect the income statement is also conferred. The case continues on the next page.

A. Explain how Xilinx's stock-based compensation plan works. What incentives do plans like this offer to employees?

Under the 2007 Equity Incentive Plan that the company has there are 16 million more shares available to be used, and there are 28.7 million shares waiting to be issued. The shares exercise value is the fair market value of the stock when it is granted to the employee. This means that the employees can buy stock years from now for the same price that the stock is selling for when they receive the options. For new employees, the vesting period is usually four years, but under the 2007 Equity plan, it is seven years. Before this plan, the vesting period was generally ten years from when the employees received them. These plans motivate employees to work harder because if the company does well, then their stock is worth more in the future. Plans like this give employees an interest in how the company does, and without them, there might be some employees who do not try to do their best work.

B. Xilinx also gives out restricted stock units or RSUs. These stocks are issued when the employee satisfies the vesting requirement. Compare the use of RSUs and stock options as a form of incentive compensation to employees. Why might both types be offered?

Stock options can be worth a lot to an employee if their company is doing well, but they can also be worthless once the vesting period has ended. If the exercise price of the stock is more than the market value when the vesting period has ended, then the stock has no value because the stock can be bought for less on the market. Restricted stock options are a less risky way of issuing stock options because they will never be completely worthless. They aren't capable of the same payouts that regular stock options are if the stock is doing well though. These restricted stock options are given to an employee once the vesting period is over, but they are given at a specified price not the market value. The different programs have different rewards and some people might prefer the riskier stock options while some might like the dependable restricted stock options.

C. Explain briefly the following terms.

Grant date: This is the date the stock options are given to the employees and the vesting period begins.

Exercise Price: This is the price that the stock options may be bought at when the vesting period is over, and it may or may not be more the fair value of the stock at that time.

Vesting Period: This is the length of time the employees must work for the company before they can buy the stock at the exercise price. If they quit before this period is over, then the forfeit their stock options.

Expiration Date: This is when the shares can't be bought anymore after the vesting date.

Options/RSU's Granted: These are the number of options or RSUs that have been granted to employees in total.

Options Exercised: This is the number of shares that have been bought after the vesting period is over.

Options/RSU's Forfeited: These are the shares that employees have forfeited either because they have left the company or because the market value of the stock is less than the exercise price.

D. Explain how the employee stock purchase plan works. What incentives does the plan provide, and how is it different from the other plans?

The company's employee stock purchase program allows employees to purchase stock at 85 percent of either the fair market value at the beginning of the 24-month offering period or at the end of the six-month exercise period. They are limited to fifteen percent of their annual earnings or a 21 thousand maximum a year. About 78 percent of employees participate in this program. This is different from the stock options and RSUs because employees can purchase them as they please. There is no long vesting period, and they have multiple opportunities to buy them. If the employees do not exceed fifteen percent of their earnings or 21 thousand dollars a year, then there is no limit on the amount of stock the employees can buy. The stock options and RSUs are given out for a specified amount. This plan also gives the employees an extra discount on the stock since they can buy it at 85 percent of the market value at the time.

E. Describe how Xilinx accounts for the employee stock option activity and the RSU activity.

The company recognizes the cost of these plans at the fair value at the grant date, and then they record the expense over the grant period that the employee is performing the service. They use the straight-line method to recognize the cost over the service period that the options have. Also, the options are classified as a compensatory plan based on the guidelines for share-based payment. When the options are exercised, cancelled, or they expire, the deferred tax assets are eliminated in a first-in, first-out basis.

F. Consider Xilinx's 2013 income statement and their 2013 statement of cash flows.

   a. What total expense does Xilinx report for their stock-based compensation in 2013?

      $77,862 thousand are reported.

b. Where on the income statement does Xilinx record this expense?

These costs are recorded in the cost of goods sold, research and development expense, and selling general and administrative expense sections. This is because each of the stock-based compensation expenses is recorded separately.

c. How does the 2013 expense affect the statement of cash flows?

The 2013 expense is added to net income in the operation section of the statement of cash flows.

d. Explain the income tax effects of Xilinx's 2013 stock-based compensation expense.

Their stock-based compensation expense decreases taxable income, so the company's taxes are less with the expense than without it.

e. Prepare the journal entry to record Xilinx's 2013 stock-based compensation expense. The following numbers are in thousands.

Cost of Goods Sold	6,356	
Research and Development Expense	37,937	
Selling General and Admin. Expense	33,569	
Paid in Capital for Stock Options		77,862

Deferred Tax Asset	22,137	
Income Tax Payable		22,137

G. Refer to the *Wall Street Journal* article titled “Last Gasp for Stock Options.”

a. What trends does the article discuss about employee stock options and restricted stock options? What do companies prefer and what do employees prefer?

The article says that stock options are becoming less and less popular to give out to employees. In 1999, they accounted for about 78 percent of executives’ compensation, and now they are just at 31 percent. The article also suggests that companies prefer to give out restricted stock options as opposed to regular ones to lower level employees. Lower level employees really do not have much sway in if the company does well or not, and since stock options are supposed to motivate employees to do well so the company does well, it does not seem to be a good way to motivate the lower level employees. Also, since restricted stock options are worth more at first, companies can give out less of them. The article also suggests that employees prefer restricted stock options more too. This is because they are generally simpler and less risky, and employees like to know they are getting their compensation that they thought they were.

b. Are Xilinx's stock-based compensation plans consistent with the trends mentioned in the article?

I think that Xilinx's stock-based compensation trends are consistent with what is talked about in the article. From April 2010 to April 2013 the number of stock options granted decreases every year. Also, during that same time frame the RSUs granted increases from 2,043 thousand to 3,018 thousand. This is consistent with the article since it said that companies and employees both prefer restricted stock options as opposed to regular stock options.

Case Number Ten:

Beer and Pretzels: Exploring the New Revenue Recognition Standard

This case differs from the others a little in that it relates to a newer standard that was passed. This standard deals with how to recognize revenue, and to learn how to deal with it, four different scenarios were used. For each scenario, the steps in the new standard were gone through one by one.

Recently there has been a new accounting standard passed having to do with revenue recognition. It now involves a five-step process to determine how and when the revenue is recognized, and the standard goes into effect in 2018. Below are some simple cases exploring how the new revenue recognition standard is used.

First Scenario

A college student walks into the Bier Haus on campus and orders a plastic cup of beer. The bartender tells him it will be $5. The student gives the bartender the money, and the bartender gives the student the beer.

1. Contract: The contract in this scenario is that the bartender is going to give the student beer if he gives the bartender the money for it.
2. Performance Obligation: Giving the beer to the student is the performance obligation that the bartender must complete.
3. Transaction Price: $5
4. Standalone Selling Price: The beer is sold for $5.
5. Recognize Revenue: The revenue should be recognized when the student gets the beer.

Journal Entry: Cash 5

Sales Revenue (beer) 5

Second Scenario

The same student walks into the store and orders a beer in a beer mug as opposed to the plastic cup from before, and the mug may be used to refills in the future. The bartender gives the student the mug and beer and collects $7 from him. If bought separately, the beer is $5, and the mug is $3.

1. Contract: This time the contract is that the bartender will give the student the beer in the mug, and the student will give him the money for it. Also, the student can come back and get refills in his mug rather than using a plastic cup.
2. Performance Obligation: Like last time, the performance obligation is that the bartender must give the student the beer in the mug.
3. Transaction Price: $7
4. Standalone Selling Price: Since there is a discount on the items when they are bought together, the relative sales price must be calculated. The beer is worth (5/8) * 7 or $4.38, and the mug is worth (3/8) * 7 or $2.62.
5. Recognize Revenue: Once again, the revenue is recognized when the student gets the beer from the bartender.

Journal Entry:	Cash	7	
	Sales Revenue (beer)		4.38
	Sales Revenue (mug)		2.62

Third Scenario

The student once again goes into the store to order a beer, but this time he brings his beer mug with him and wants a pretzel. They are out of pretzels, so the bartender offers the student a beer and coupon for two pretzels for $7. The student gives the bartender $7, and the bartender gives him his coupon and beer. Standalone selling price is $5 for the beer and $2 for a pretzel. Also, the store sells the coupons for two pretzels for $3.50, and they can be used on any day after the purchase. So far, the coupons the store has sold have always been redeemed.

1. Contract: The contract is that the student will give the bartender money, and the bartender will give him his beer and the coupon.
2. Performance Obligation: The performance obligation is the bartender giving the student the beer and the coupon.
3. Transaction Price: $7
4. Standalone Selling Price: Like in the second scenario, the relative sales price is going to have to be used. So, the beer is worth (5/8.50) * 7 or $4.12 and the coupon is worth (3.50/8.50) * 7 or $2.88.
5. Recognize Revenue: The revenue is recognized on the beer when the bartender gives the student the beer, and revenue is recognized on the coupon when it is redeemed.

Journal Entry:	Cash	7	
	Sales Revenue (beer)		4.12
	Unearned Revenue		2.88

Fourth Scenario

For the fourth time, the same student walks into the store and orders two pretzels. The bartender asks for $4, but the student hands the bartender the coupon instead. Once the bartender has determined that the coupon is valid, he accepts it as payment and gives the student two pretzels for it.

1. Contract: The contract is that the bartender will accept the coupon in exchange for two pretzels.
2. Performance Obligation: The bartender giving the pretzels to the student in the performance obligation.
3. Transaction Price: The transaction price should be $0 since no money is being exchanged. The pretzel has already been paid for when the student bought the coupon for it.
4. Standalone Selling Price: The standalone selling price of the two pretzels is $4.
5. Recognize Revenue: The revenue for the pretzel is recognized when the bartender hands the student the pretzels in exchange for the coupon.

Journal Entry:	Unearned Revenue	2.88	
	Sales Revenue (pretzels)		2.88

Case Number Eleven:

ZAGG Company: Deferred Income Taxes

This case deals with deferred income taxes and the correct treatment of these items. The topics discussed include temporary tax differences, permanent tax differences, and deferred income tax valuation allowances, and the company in this case is ZAGG Company. More information can be found below.

ZAGG stands for Zealous About Great Gadgets, and it is a company that designs protective shields for wristwatches. They are also a market leader in mobile device accessories. Below are some questions about ZAGG company pertaining to their deferred income taxes from 2010 to 2012, and the numbers included in this case are all in thousands.

A. Describe what is meant by the term book income. Which number represents this for ZAGG and describe how this differs from the taxable income.

   Book income is the same as financial income, and it is the income that is shown on the financial statements. This includes all items on the financial statements whether it is taxable or not. On ZAGG's financial statements, the net income number is the one that represents book income. The difference is that taxable income only includes items that are used for taxes, so financial income shows a more complete picture of what happened throughout the year.

B. Define the following terms.

   a. Permanent Tax Differences: These are transactions that are reported differently for financial and tax purposes, and they are only for the tax year in which they occur. These differences don't reverse, and example would be interest earned from tax-exempt bonds.

b. Temporary Tax Differences: These are also transactions that are reported differently for financial and tax purposes, but they occur over several years instead of one year. These tax differences end when the differences reverse, and it all evens out. One example of a temporary tax difference is for nonqualified deferred compensation

c. Statutory Tax Rate: This is tax rate imposed by the law.

d. Effective Tax Rate: This is the average rate at which an individual or corporation is taxed that is used on the income statement. It is the tax rate that it appears the company is paying taxes at because of the differences between the book income and the taxable income.

C. Explain why a company reports deferred income taxes as part of their total income tax expense. Why don't companies simply report their current tax bill as their income tax expense?

Deferred income taxes are taxes that haven't been paid yet, but they have been incurred. These are reported along with the year's income tax expense to show the whole picture. If you only showed the current year's taxes, then that would not be disclosing everything that you should be.

D. Explain what deferred income tax assets and deferred income tax liabilities represent. Give an example that would give rise to both.

Deferred tax assets are assets on the company's balance sheet that can be used to reduce company's income tax expense, and deferred tax liabilities are liabilities that are used to increase a company's income tax expense. An example of a deferred tax asset is when expenses are recognized before they are required to be by the tax authorities, and an example of a deferred tax liability would be just the opposite of the deferred income tax asset.

E. Explain what a deferred income tax valuation allowance is and when it should be recorded.

A deferred income tax valuation allowance is used when a company does not believe they will be able to realize all their deferred tax assets, and the allowance is set up to offset the deferred tax asset. A business should create a deferred income valuation allowance if there is more than 50 percent chance that the company will not realize a portion of the asset. These allowance accounts are more likely if the company expects to incur losses in the next couple of years.

F. Consider the information disclosed in note eight.

a. Show the journal entry that ZAGG recorded for the income tax provision in fiscal 2012.

Income Tax Expense	9,393	
Net Deferred Tax Asset	8,293	
Income Tax Payable		17,686

b. Decompose the amount of "net deferred income taxes" recorded in the income tax journal entry recorded above into its deferred income tax asset and deferred income tax liability components.

Income Tax Expense	9,393	
Deferred Tax Asset	8,002	
Deferred Tax Liability	291	
Income Tax Payable		17,686

c. The federal statutory rate for ZAGG is 35 percent. Calculate ZAGG's 2012 effective tax rate using the information in their income statement and note eight. What accounts for the differences between the statutory tax rate and the effective tax rate?

Effective Tax Rate = Tax Expense / Pre-Tax Income

9,393 / 23,898 = 39.3% is the effective tax rate

The difference in the tax rate comes from many different accounts. These include state taxes, non-deductible expenses, domestic production activities, return to provision adjustments, and increases in the valuation allowance.

d. According to the third table in note eight, ZAGG had a net deferred income tax asset balance of $13,508 at December 31, 2012. Explain where this amount appears on ZAGG's balance sheet.

This amount appears as a current deferred tax asset under the current asset section and it is $6,912, and it also appears as a noncurrent deferred tax asset of $6,596 in the other assets. Together these give you the $13,508.

Case Number Twelve:

Build-A-Bear Workshop: Leases

The last case in this thesis deals with leases, and how to properly account for them either as operating leases or capital leases. Build-A-Bear is the company in this case, and the requirements for being a capital lease are discussed. Specific information relating to Build-A-Bear is on the next page.

Build-A-Bear Workshop is a company that allows you to create your own stuffed animal, and there are more than 400 stores worldwide. Below are questions and answers related to Build-A-Bear Workshop, and the selected financial information that was presented. These questions are related to leases, and more specifically the differences between capital leases and operating leases.

A. Why do companies lease assets rather than buy them?

   There are many reasons companies choose to lease assets rather than buy them. One is if you lease an asset then you don't have to keep it if it becomes obsolete, and it provides more flexibility than buying. Also, there can be tax advantages to leasing as opposed to buying, and it provides off balance sheet financing. In general, the financing is just less costly overall.

B. What is an operating lease, and what is a capital lease? What is a direct-financing lease, and what is a sales-type lease?

   Capital leases are leases that are noncancelable and meet one or more of the capital lease criteria, and operation leases are all other leases. The criteria for it to be considered a capital lease includes:

   1. Transfer of ownership of the property
   2. Contain a bargain purchase option

3. The lease term is equal to 75 percent or more of the economic life of the property
4. The present value of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the property

Sales-type leases and direct-financing leases are both different types of capital leases. Sales type leases meet one or more of the capital lease criteria and give profits to the lessor, and direct financing leases meet on or more of the capital lease criteria and do not give profits to the lessor.

C. Why do accountants distinguish between different types of leases?

Accountants distinguish between different types of leases because they are used for different purposes. It depends what the company wants on their balance sheet, assets or liabilities. Also, they are distinguished for tax purposes. Not distinguishing between the different types of leases wouldn't be disclosing everything.

D. Consider the following hypothetical lease for Build-A-Bear:

- The lease term is five years
- Lease payments of $100,000 are due on the last day of each year
- There is not a bargain-purchase option and title does not transfer at the end of the lease

- The expected useful life is 25 years, and the fair value is estimated to be $1,500,000

a. Will this lease be treated as an operating lease or a capital lease under current US GAAP?

   This will be an operating lease because the lease term is only five years out of its 25-year useful period which is not at least 75 percent of the useful life. Also, the fair value of the minimum lease payments does not equal 90 percent of the fair value of the leased property, and there is neither a bargain-purchase option or a transfer of title at the end of the lease. In other words, this lease does not meet any of the four criteria to be a capital lease.

b. Provide the journal entry that Build-A-Bear will record when it makes its first lease payment.

   Rent Expense 100,000

   Cash 100,000

c. Assume that second lease is identical to above, but the first year is "rent free." So, Build-A-Bear is paying $125,000 at the end of years two through five instead of the $100,000. Provide the journal entries that the company will make over the term of this lease.

End of Year One:	Deferred Rent Expense	100,000	
	Rent Payable		100,000
End of Years Two:	Rent Expense	125,000	
Through Five	Cash		125,000
	Rent Payable	25,000	
	Deferred Rent Expense		25,000

E. Consider Build-A-Bear's operating leases and the information shown in Note 10, Commitments and Contingencies. Further information about their operating leases is listed in Note 1.

a. What was the amount of rent expense on operating leases in fiscal 2009?

Rent Expense on operating leases for 2009 is $45.9 million and $0.9 million so $46.8 million in total.

b. Where does that expense appear on the companies Income Statement?

It appears in the selling, general, and administrative section of the income statement.

F. Recent proposals by the Financial Accounting Standards Board would largely eliminate the use of operating leases. Most leases would be accounted for by capital leases instead, and the present value of the expected lease payments would be treated as a "right to use leased asset."

a. Calculate the present value of the future minimum lease payments at January 2, 2010. Assume the implicit interest rate is seven percent.

Year	Lease Payment	Present Value	Present Value of Payment
1	50,651	0.9346	47,337
2	47,107	0.8734	41,145
3	42,345	0.8163	34,566
4	35,479	0.7629	27,067
5	31,319	0.7130	22,330
6	25,229	0.6663	16,811
7	25,229	0.6227	15,711
8	25,229	0.5820	14,684
			$ 219,651.38

b. Had Build-A-Bear entered into these leases on January 2, 2010, what journal entry would the company have recorded if the leases were considered capital leases?

Property and Equipment 219,651

Lease Obligation	219,651

c. What journal entries would the company record in fiscal 2010 for these leases if they were considered capital leases?

Lease Obligation	35,276	
Interest Expense	15,375	
Cash		50,651

Depreciation Expense	27,456	
Accumulated Depreciation		27,456

G. Under current US GAAP, what incentives does Build-A-Bear's management have to structure their leases as operating leases? Comment on the effect of leasing on the quality of a company's financial reporting.

Operating leases have tax benefits that capital leases don't. You can deduct the rent expense instead of having an asset on the books. Since there are different ways to account for leases companies that are basically in the same lease could have leases that are recorded in different ways. This makes it hard to compare financial statements, and the quality of the financial reporting goes down.

H. If Build-A-Bear had capitalized their operating leases, key financial ratios would have been affected. Refer to the solution in part F to compute the potential impact on the current ratio, the debt-to-equity ratio, and the long-term-debt-to-assets ratio at January 2, 2010.

As is with operating leases:

- Current Ratio: 135,755 / 81,890 = 1.658
- Debt to Equity Ratio: 119,493 / 164,780 = 0.725
- Long term Debt to Assets Ratio: 37,603 / 284,273 = 0.132

If the leases were capitalized:

- Current Ratio: 135,755 / (81,890 + 47,388) = 1.05
- Debt to Equity Ratio: (119,493 + 219,651) / 164,780 = 2.06
- Long term Debt to Assets Ratio: (37,603 + 219,651 - 47,388) / (284,273 + 219,651) = 0.416